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SUBJECT: JAMAICA: BUSINESS AND CONSUMER CONFIDENCE SURGE, BUT WILL HISTORY REPEAT ITSELF?

SUMMARY

1. Business and consumer confidence surged in the first quarter of 2007, reflecting declining prices and interest rates and the euphoria surrounding the Cricket World Cup (CWC). Consumers were more confident about their economic prospects at the start of 2007 than at any other time since 2001, while businesses liked their financial prospects. These findings mirror the survey results from the period immediately prior to the 2002 general elections, when confidence peaked before plunging as the real state of the economy emerged. As in 2002, consumers and businesses are bullish about the short-term prospects of the economy. But while consumer optimism might be explained by CWC and the spending binge generally associated with elections, it is difficult to justify business confidence, given the emerging fiscal difficulties. While no tax package is expected before the elections, the GoJ will only be postponing the inevitable, as regardless of which party wins upcoming general elections, taxpayers can expect to face higher taxes to narrow the financing gap and or expect a steep reduction in public goods and services. Even these austerity measures might not be sufficient to calm the capital market, which has seen this scenario all too often, and could result in massive adjustments in the economy. End summary.

Consumer Confidence at Record Level

2. Jamaican consumers expressed the greatest level of confidence about their future economic prospects at the beginning of 2007 than at any other time since the survey started in 2001. According to the Jamaica Chamber of Commerce's Survey, the Index of Consumer Confidence rose to a record 138.1 at the end of March 2007, up from 128 in the previous quarter. However, unlike the last quarter of 2006 when confidence was driven by Kingston residents, the current gains stem from residents in resort areas. Consumers are pinning their hopes on further improvements in the economy, with 65 percent anticipating the gains to at least remain constant. In particular, consumers were buoyed by the: (a) up tick in economic growth; (b) moderation in inflation to 5.8 percent; (c) declining interest rates; (d) euphoria surrounding the staging of Cricket World Cup 2007; and, (e) expectations of record tourist arrivals in 2007.

More Jobs Finally?

13. The improved economic performance is expected to bring increased job opportunities, so when asked about future job prospects, Jamaican consumers expressed the highest level of optimism since the survey started. An adequate supply of jobs was reported by 30 percent of residents in resort areas, 20 percent of Kingston residents and 25 percent of residents in other areas. The response from residents in tourist areas suggests anticipation of another year of record tourist arrivals, especially given the boom in hotel construction. But consumers were even more excited about gains in their incomes, with almost 60 percent of households anticipating increases. This finding might not be surprising given that the GoJ has already spent close to USD 15 million on a clean-up campaign, commonly referred to as a "crash program." (Note: a crash program is the spending of large amounts of public money in politically-sensitive and/or contentious areas, seen as an attempt to buy votes. Endnote) With general elections approaching, consumers would expect this spending to intensify. Strangely, increased spending plans are not expected to accompany the higher incomes, with home, vehicle and vacation plans cut in half. The cautious spending plans suggest that consumers are aware that the hype will be temporary.

Businesses Follow Suit

14. The Index of Business Confidence jumped to 126.7, just below the all time high of 127.3. So positive were firms about the economic prospects that only 21 percent expected the economy to worsen during the year, down from 45 percent in the last quarter. But even as confidence in the economy surged, firms remained concerned about the high costs of crime, with two-thirds of all firms citing the associated costs as the main obstacles to a more sustained period of positive economic growth in Jamaica. Businesses were also upbeat

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about their profits: two-thirds of all firms expected increased profits during the year ahead, the highest proportion recorded since 2001. This expectation is not surprising and could also be attributed to the anticipated spike in spending leading up to the elections. A record number of firms also anticipated a general improvement in their financial situation, and with the general business climate improving a record number of firms are planning new investments. Investments were planned by 48 percent of all firms, while only 33 percent of firms thought it was a bad time to invest, the lowest level registered since 2001. This particular finding is curious, given the emerging fiscal difficulties, the correction of which could impact the very factors determining investment decisions.

More of the Same

15. The current findings of consumer and business confidence almost mirror the survey results leading up to the 2002 elections. In fact, Minister of Finance and Planning Omar Davies, in delivering his 2002/03 budget, boasted about another business survey showing that 40 percent of business leaders expected the economy to grow by up to four percent. But more importantly, the overwhelming majority expected lower inflation, exchange rate stability, and a continued lowering of interest rates. Davies went on to stress that he was not presenting an election budget in the old-time sense where there were numerous "goodies" in an attempt to influence the electorate. Davies also presented a relatively tight macroeconomic program, with an inflation target of 5-6 percent, GDP of 2-4 percent and a fiscal deficit-to-GDP target of 2.5 percent.

16. By the end of December 2002, however, Davies - in his now infamous "run wid it" speech - admitted that he had intentionally increased expenditures to gain a political advantage for his administration. Davies later acknowledged the gravity of the fiscal and debt situations, fuelling instability in the foreign exchange market. To address this instability the central bank embarked on a number of corrective measures, including a hike in benchmark

interest rates from 17 to 36 percent. By the end of the 2002/03 fiscal year the GoJ had missed all of its economic targets, with the fiscal deficit above target by 5.2 percent of GDP. This led to a loss of credibility in the international capital market, forcing the GoJ to impose one of the largest tax packages in the country's history. The evidence therefore suggests that confidence is at best tenuous and is largely driven by short term prospects. This period is not only devoid of taxes, but is generally characterized by increased spending, especially on "crash programs" for the poor.

So is Another Crisis Looming?

17. Despite improvements in the current economic fundamentals, a number of challenges remain which, if unattended, could set the stage for a reversal of those recent gains. Data for the fiscal year shows that the fiscal deficit-to-GDP is running at about five percent, well above the original target of 2.5 percent of GDP. And while the GoJ has tabled a tight expenditure budget for the 2007/08 fiscal year, this is widely viewed as an underestimation of the "real" budget, which will include election spending, and will only emerge when the GoJ has to table its revised projections at the end of the fiscal year. This anticipated spending will not be accompanied by increased revenue, which could lead to further fiscal deterioration. This will force the GoJ to postpone its balanced budget target from 2007/08 to sometime in the medium term, particularly as Prime Minister Portia Simpson-Miller pursues her campaign slogan to "balance lives." While this might find favor with the electorate, it might not be so well received by the international capital market. Already Bear Stearns has downgraded Jamaica's bonds to "market under-perform" based on these fiscal concerns. The investment bank does not expect any positive surprises from the budget and has expressed disappointment in the fiscal accounts given the absence of shocks in 2006.

COMMENT

18. While confidence in the international capital market is beginning to wane, local optimism could remain high until after the elections. As the true fiscal picture begins to emerge, however, there could be a concurrent decline in confidence. In fact, a number of

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additional factors could combine to lead to a plunge in confidence as observed after the last general elections. The 2007 Cricket World Cup is turning out to be a disappointment from a financial standpoint. The fact that the home team is not doing well has only added to several negatives plaguing the event, dampening the euphoria which helped to boost confidence in the first place. Additionally, the bumper tourism season forecast by the Tourism Ministry and anticipated by residents in resort areas is not materializing, and this will have a negative impact on foreign exchange earnings and economic growth. If history repeats itself, there could be heavy tax measures in the near future to front-load the adjustments necessary to stabilize the economy. This would be disconcerting, as Jamaican taxpayers would again be expected to absorb a decline in their standard of living to compensate for another bout of election year fiscal imprudence. End comment.

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